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SUMMARY

1. Introduction

This paper presents USAID/E&E's system for monitoring country progress in the 27 transition country region. It is the seventh update of the original January 1997 report. As in past editions, transition progress is tracked along four primary dimensions: (1) economic reforms; (2) democratization; (3) macroeconomic performance; and (4) social conditions. An important objective of this report is to provide criteria for graduation of transition countries from USAID assistance, and, more generally, to provide guidelines in optimizing the allocation of USAID resources in the region.

2. Findings

Widespread diversity among the 27 transition countries continues to characterize progress towards market-oriented democracies. This is a primary theme across several transition dimensions, including: (1) economic and democratic reforms; (2) macroeconomic performance and global integration; and (3) social conditions.

(1) Economic and democratic reforms. Two key observations emerge from *Summary Figure 1*. First, the Northern Tier CEE countries remain significantly out front of the rest of the transition countries in progress towards economic and democratic reforms. There are broadly two groups of transition countries differentiated by reform progress, a "well-defined" or closely clustered Northern Tier CEE group and the rest (which are characterized by very large differences in reform progress among them). Second, the range in progress across countries is significantly greater in democratic reforms than in economic reforms. The reform leaders have democratic freedoms roughly on a par with some Western democracies, while the democratic laggard, Turkmenistan, scores among the least democratic countries worldwide. However, even the Northern Tier CEE countries continue to lag considerably behind the EU in economic reforms, particularly evident in the second stage reforms (which focus in large part on building a government's capacity to govern).

2001-2002 reform trends. Notable economic reform progress has been made in 2001-2002, largely a continuation of significant gains made in 2000. Roughly two-thirds of the transition countries measurably advanced in economic reforms in 2001-2002, many of these in both economic reform stages. In fact, in 2002, most of the economic reform gains were second stage (structural or institutional) reforms, all the more impressive given the context of a sluggish world economy (which contributed, among other ways, to a diminished supply of interested international investors in the region). Countries that have made the greatest advances in economic reforms since 2000 include Yugoslavia, Croatia, Bulgaria, Slovakia, Lithuania, Russia, and Kazakhstan. Yugoslavia has made far and away the greatest economic reform gains in 2002, followed by Russia, then Bosnia-Herzegovina and Latvia.

The most recent efforts to measure democratic reforms show: (1) four of the Southern Tier CEE countries advancing in democratization in 2001 (Yugoslavia, Bosnia-Herzegovina, Bulgaria, and Albania), with only one backslider, Macedonia; (2) six Eurasian countries backsliding (Georgia, Moldova, Ukraine, Russia, Kyrgyzstan, and Kazakhstan), while only one Eurasian country moved forward (Azerbaijan); and (3) relatively little change in the Northern Tier CEE countries (with Slovakia and Estonia advancing and the Czech Republic slipping).

Qualitative and anecdotal evidence suggest that the trend towards a growing democratization gap between the transition leaders and laggards has continued in 2002. In particular, most of the developments on political reforms in Eurasia in 2002 have underscored further backsliding. This includes adverse democratization trends in Armenia (media), Kazakhstan (media and electoral reforms), Kyrgyzstan (media), Moldova (political freedom), Russia (constitution and media), Tajikistan (civil liberties towards minority groups), and Uzbekistan.

Medium term reform trends. Of the three sub-regions, the Southern Tier CEE countries have made the greatest reform gains since 1997; overall, they are catching the Northern Tier CEE countries in reform progress, and are pulling away from many of the Eurasian countries. In 1998, the Southern Tier CEE countries had a range of reform progress across countries roughly similar to that found among "reformers" in Eurasia. Since then, the reform profiles between the Southern Tier CEE and Eurasian countries have become increasingly distinct. In addition, since 1997, the reform profiles among the Northern Tier CEE countries have become increasingly similar; since 1998, Slovakia has joined the "fold", and, more generally, the differences in reform progress between the eight Northern Tier CEE countries have decreased, and have become relatively insignificant. Overall reform progress in the three or four Northern Tier CEE leaders has been modest in recent years, partly reflecting approaching "ceilings" in reforms (particularly in democratization), and partly reflecting that second stage transition reforms (particularly in economic reforms) are more difficult than those typically done in early transition years.

Reform paths. Most transition countries have exhibited at least temporary backsliding and/or progress in "fits and starts" at best since the transition began. Nevertheless, there has been a key distinction between reform paths in the CEE and Eurasian countries. While most of the CEE countries have experienced some temporary reform backsliding and/or stalling, all (with the possible exception of Bosnia-Herzegovina) have moved forward in both reform dimensions since the transition began. Progress in both economic and democratic reforms, in other words, is consistent in this group, and apparently mutually reinforcing. In contrast, while all of the Eurasian countries have witnessed gains in economic reforms since 1991, for most, this has been accompanied with regression in democratic freedoms on balance. In an important respect, a decisively different reform path has so far emerged in Eurasia, some forward progress in economic reforms alongside backsliding in democratization.

(2) Macroeconomic performance and integration into the world economy. Overall macroeconomic performance since 2000 has been impressive in the transition region, characterized by strong economic growth across the three sub-regions, and low and/or falling inflation throughout the sub-regions. Moreover, the transition countries have generally exhibited greater resilience to the global downturn than other emerging markets.

Overall economic growth in the transition region in 2001 was 5.6%, higher than all other transition years but the previous one; in 2000, the region expanded by 6.4%. The transition economies are currently estimated to grow on average by 3.4% in 2002; highest in Eurasia at 4.4%, followed by 3.6% in the Southern Tier CEE, and 2.3% in the Northern Tier CEE. By contrast, the EU economies are likely to expand only by roughly 1% in 2002. Of all the 27 transition countries, only Macedonia had a contracting economy in 2001. All transition countries are on track towards experiencing economic growth in 2002. Inflation has fallen to the single-digit range in all but a handful of transition economies. Nevertheless, fiscal deficits remain too high in roughly one-half of these economies.

Global integration. While macroeconomic performance has been impressive across the sub-regions, some of the bases underlying the strong performances continue to differ between CEE and Eurasia, in large part stemming from significant differences in how (and to what extent) the countries are integrated into the global economy. Overall, economic growth may be more sustainable in CEE than in Eurasia.

The Eurasian countries are much more "inward-oriented" (or autarkic) than the CEE countries, with export and foreign direct investment (FDI) shares of GDP comparable to the relatively inward-oriented, poorer economies of South Asia and Sub-Saharan Africa. The Northern Tier CEE countries have the largest export and FDI shares of GDP of the three transition sub-regions, though even among these countries, the data suggest there is considerable scope for greater trade with the West.

The Eurasian countries are much more dependent on natural resource exports (energy, metals, and agricultural raw materials such as cotton) than are the CEE countries. Almost one-half of Eurasian exports are of this kind. In CEE, these primary product exports constitute only 15% of total exports. The CEE countries have substantially restructured and diversified trade flows as well; their economic links to Western Europe are significant and continue to grow. In contrast, Russia continues to dominate economic links within Eurasia, though this dominance is declining.

In addition, institutional integration with the advanced economies remains largely a process confined to the transition countries in CEE. The significance of this, both for the CEE countries and Eurasia, can hardly be overstated. For the CEE countries, membership into the EU and other Western institutions (such as NATO) provide a strong incentive as well as a key means for advancement. However, particularly in the case of the EU expansion, the gains accrued to new members are to some extent offset by the cost of exclusion to those countries left on the "sidelines," or, in this case, Eurasia.

(3) Social conditions. There continue to be significant differences in social conditions across the transition region. Conditions are generally much worse in Eurasia than in CEE, and there is evidence that health and education challenges in parts of Eurasia are growing. Nevertheless, there may be emerging some favorable trends in Eurasia as well, at least in Russia, that suggest that the macroeconomic gains are beginning to filter down to at least some of the population.

Labor markets. Highest unemployment rates are in the Southern Tier CEE, ranging from roughly 9% in Romania, to 15-19% in Croatia, Bulgaria, and Albania, to closer to 30-40% in Yugoslavia, Macedonia, and Bosnia-Herzegovina. Youth unemployment rates are much higher still in the Southern Tier CEE. Unemployment is also high in the Northern Tier CEE countries, 15% on average; in contrast to trends in Western Europe, these rates have been increasing since 1997. There are at least two key reasons why official unemployment rates in Eurasia are generally lower than in CEE. First, the unemployment data in Eurasia remain less reliable and/or are not directly comparable to those in CEE. Second, labor markets have adjusted differently in Eurasia, partly a reflection that enterprise restructuring continues to lag in much of Eurasia vis-à-vis CEE. In lieu of labor shedding by Eurasian enterprises, price adjustments (i.e., falling real wages), and/or wage arrears, and hidden unemployment or more broadly underemployment have tended to characterize many Eurasian labor markets.

Income and poverty. Per capita income (at $6,900 in purchasing power parity terms) for the transition region overall is only one-fourth the average of the advanced economies ($28,550). However, this average masks wide variation. Four Northern Tier CEE countries have average income greater than $10,000 (Slovenia, the Czech Republic, Hungary, and Slovakia), while three Eurasian countries have average income levels closer to $2,000 (Uzbekistan, Moldova, and Tajikistan). Moreover, income is much more evenly distributed in the Northern Tier CEE, comparable now to inequality found in the EU. In contrast, income inequality in a handful of Eurasian countries, most notably Armenia, followed by Russia, Tajikistan, and Kyrgyzstan, may approach those levels found among the most unequal economies worldwide, in Latin America and Sub-Saharan Africa. Poverty rates are also much higher in Eurasia than in CEE, though cross-country estimates vary widely according to different poverty thresholds.

Nevertheless, household survey data of poverty and living standards in Russia (from the Russian Longitudinal Monitoring Survey) provide evidence that the recent gains in Russia accrued at the macroeconomic level have been filtering down quite substantially. What is striking in these data is how closely the trends in poverty rates map with macroeconomic trends. Specifically, the poverty rate in Russia continued to rise while the economy contracted, i.e., through 1998. However, once economic growth got underway, the poverty rate started falling dramatically, from 39% of the population in 1998 to 29% in 2000 to 19% in 2001. Moreover, extreme poverty as a proportion of total poverty has also been falling in Russia. In addition, RLMS data show, with one exception, that regional poverty rates within Russia diverge relatively little from the national mean. Five of the six regions assessed had poverty rates in 2000 that varied by six percentage points or less around the national poverty rate of 29%; the Moscow and St. Petersburg region had a poverty rate of 15%.

Human capital. Life expectancy is now higher today in a large majority of the transition countries than at the outset of the transition. For most countries, this has meant a temporary decline followed by a more than proportionate increase in life expectancy. However, there are at least four notable exceptions: Russia, Belarus, Kazakhstan, and Ukraine all had lower life expectancy in 2000 (the latest year available) than in 1989. All four countries have seen a decline in life expectancy in both males and females. The most alarming trends are in Russia, where after stabilizing for several years, life expectancy has resumed a downward trend (and despite the encouraging income and poverty trends noted from the RLMS data above). In addition, with few exceptions, the gender gap in life expectancy (that is, female minus male life expectancy) is very high in the transition region; generally much higher than in other parts of the world.

From 1990 to 2000, infant and child mortality rates fell in all three sub-regions, by about 20% for the transition regional overall. However, infant and child mortality rates on average in the Southern Tier CEE and in Eurasia are at least twice the Northern Tier CEE rates, depending on data sources.

World Bank data show a small decline in primary and secondary school enrollments in the transition region from 1989/90 to 1997/98 from relatively high enrollment levels. However, differences between sub-regions are significant, particularly in regards to secondary school enrollment; more recent UNICEF data show large drops in enrollments have occurred in some of the poorer transition countries, including Tajikistan, Georgia, Moldova, and Albania.

Social capital (and reform fatigue). Finally, in addition to humanitarian considerations and concerns about human capital deterioration, social conditions matter because without adequate support from the general population, moving forward on transition reforms may be very difficult. In this context, household survey data show that trust in institutions (a rough proxy for social capital) is very low. This applies to public institutions from the parliament, the courts, and civil servants more broadly, as well as to private institutions, including the press and private enterprise. Nor are many people pleased with their own household economic situation. This applies even in the Northern Tier CEE: in 2001, 72% of Slovakians claimed to be unsatisfied with their economic conditions; 70% in Poland; 49% in the Czech Republic; and 37% in Slovenia. Dissatisfaction is highest in Russia (the only Eurasian country included in this sampling of seven countries); 85% of the Russians sampled were dissatisfied. Dissatisfaction in household economic conditions has been very high in Bulgaria as well: 82% in 2001

Finally, how many people want to return to communism? While not nearly as large as the proportion of those who are dissatisfied with their economic conditions, the percentage of those who maintain that they want to go back to communism is significant, and in many cases, continues to increase. It is highest in the three Eurasian countries sampled: 51% in Ukraine (in 1998); 47% in Russia (in 2001) and 33% in Belarus (in

1998). However, it is also close to 20% of the population in Hungary, Romania, Slovenia, Poland, and Bulgaria. It is lowest in the Baltics (9% in 2001).

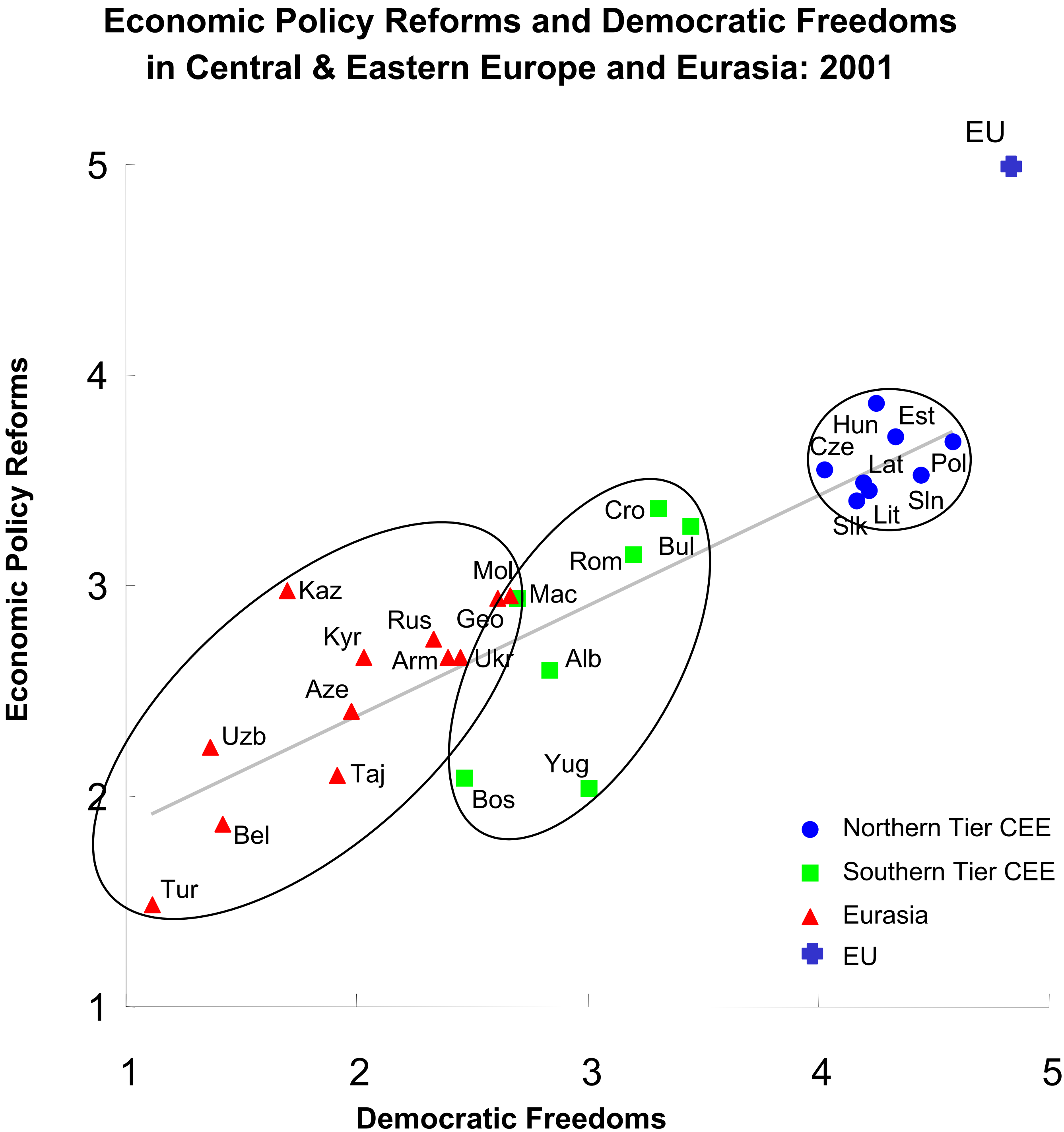
3. Concluding Remarks

Decisions on the magnitude and duration of U.S. assistance to the transition region are made on the basis of several factors: (1) progress the country has made towards a sustainable transition to a market-based democracy; (2) strategic importance of the country to the United States; (3) importance of the recipient country to U.S. citizens; and (4) effectiveness of particular assistance activities.

This paper provides the basis to analyze the first factor. An application of the *Monitoring Country Progress* data set for this purpose of facilitating USAID graduation decisions is done in a sequence of steps. First, progress in both economic and democratic reforms need to attain certain thresholds before graduation from USAID assistance can be considered (*Summary Figure 1*). Reform benchmarks are provided in the tables that accompany this paper. Second, trends in macroeconomic and social conditions need to be sufficiently favorable so that reform gains can be sustained. At the least, macroeconomic stability and broad-based economic growth need to be achieved and maintained, while key social conditions advance towards Western Europe standards.

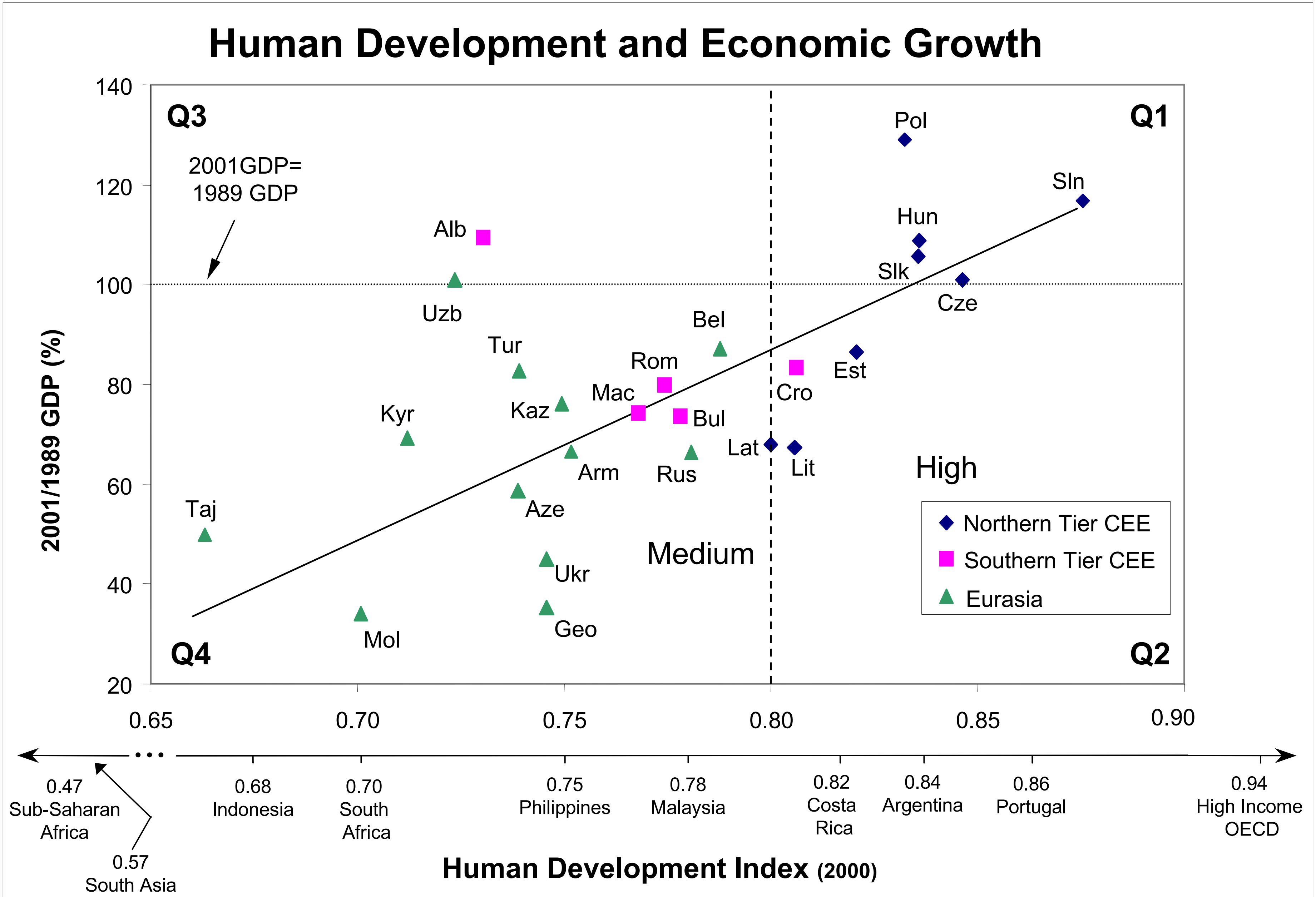
Summary Figure 2 provides a summary snapshot of the progress of the transition countries along these latter two dimensions tracked in this paper. Macroeconomic performance is measured by GDP trends since 1989; social conditions are measured by the UNDP's human development index. As shown, the majority of transition countries remain in the quadrant characterized by economies that have not yet attained pre-transition output levels and by societies that are defined by the UNDP as having "medium" human development (*Quadrant 4*). The quadrant characterized by current GDP exceeding pre-transition income and "high" human development (*Quadrant 1*) would seem to be a credible "location" for countries ready for graduation from USAID assistance. It is also important that the trends over time at the least do not show notable deterioration in social and macroeconomic indicators.

Summary Figure 1



Ratings of democratic freedoms are from Freedom House, *Nations in Transit 2002* (2002), and cover events through December 31, 2001. Economic policy reform ratings are from EBRD, *Transition Report 2001* (November 2001), and cover events through September 2001. Economic policy reforms include price liberalization, trade and foreign exchange, privatization, legal, banking and capital markets, enterprise restructuring (credit and subsidy policy), and infrastructure reforms. Democratic freedoms include political rights (free and fair elections; openness of the political system to competing political parties and to minority group representation; governance and public administration) and civil liberties (free media and judiciary; freedom to develop NGOs and trade unions; equality of opportunity and freedom from corruption). Ratings are based on a 1 to 5 scale, with 5 representing most advanced.

Summary Figure 2



Albania and Uzbekistan are not included in the trend-line calculation.

The Human Development Index (HDI) is based on three indicators using 2000 data: longevity, as measured by life expectancy; educational attainment, as measured by a combination of adult literacy and combined primary, secondary and tertiary enrollment ratios; and standard of living, as measured by real per capita GDP ($PPP). The HDI ranges from 0 to 1, with higher values representing greater human development. UNDP, *Human Development Report 2002* (July 2002); EBRD, *Transition Report 2001* (November 2001).